



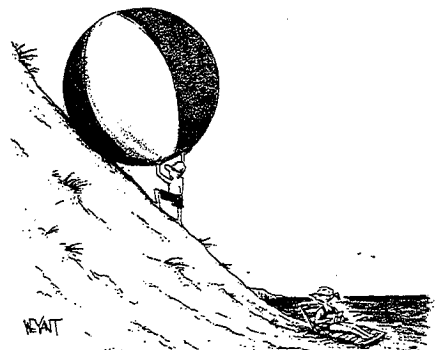
CHOICE OF ENTITY THE DEVIL IS IN THE DETAILS

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*"I do think your problems are serious, Richard.
They're just not very interesting."*



"Can't you ever relax?"

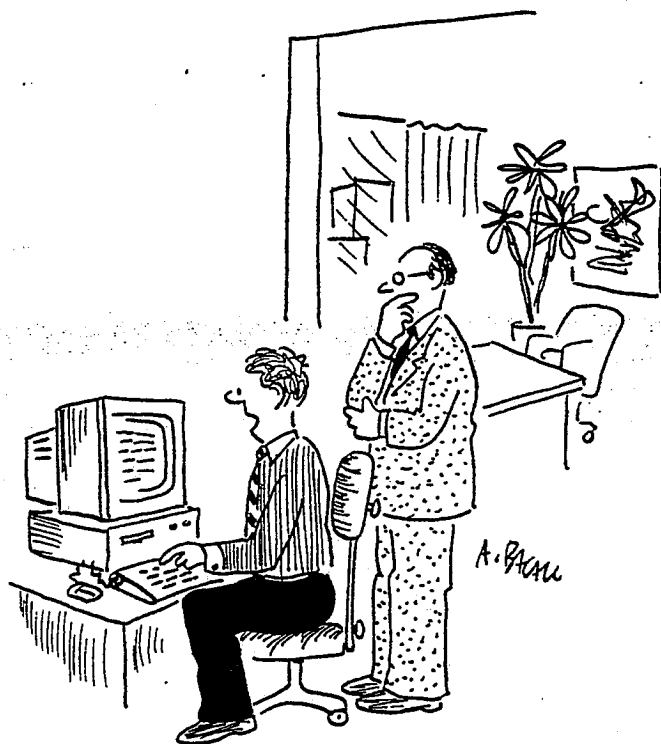
CHOICE OF ENTITY

- Choosing the right entity is a big decision with far reaching implications
 - Far too often the choice is based on what the client needs today
 - Which form of entity is optimal frequently changes over the life cycle of the business
 - The future belongs to the entities which have flexibility to adapt to both changing needs and unforeseen circumstances
 - Far too often the choice is based on what is easiest or cheapest
 - Far too often the choice gets made before the client has been fully educated on what alternatives might be considered or even what factors may affect the choice

- The choices include:
 - Sole proprietorship
 - Association of two or more owners treated as separate proprietorships
 - General partnership (GP)
 - Limited partnership (LP)
 - Limited liability partnership (LLP)
 - Limited liability limited partnership (LLL)
 - LLC
 - Series LLC
 - C-corp (business or professional)
 - S-corp (business or professional)
 - Nonprofit corporation
 - Various forms of trusts



"Paper or plastic?"



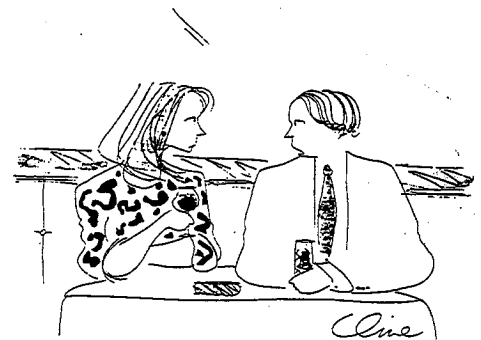
"It's a brilliant plan, I.B. The upside is huge profits, but the downside is 500 hours of community service."

FACTORS TO CONSIDER

- Some basic factors to consider are
 - Simplicity
 - Flexibility
 - Ease of getting investment in or out
 - Ease of electing the most appropriate tax return to match the current needs of the business
 - Corporations have two choices (C-corp or S-corp)
 - All other entities have up to 4 choices (C-corp, S-corp, Partnership, or Disregarded Entity)
 - Availability to single owner
 - Cost to form and costs to maintain
 - Liability Protection
 - Not all entities provide limited liability protection
 - Always consider both inside (arising from activities of the business) and outside (arising from the activities of the owners) liabilities
 - Watch out for changes in liability protection as the entity crosses state borders
 - Single owner entities may face extra challenges
 - Control
 - Corporations are democracies
 - LLCs, Partnerships and Proprietorships can be dictatorships
 - Control by a non-owner
 - Control by a minority owner
 - Familiarity
 - Does the client understand the legal, tax, and accounting formalities
 - Does the client's CPA understand the legal, tax, and accounting formalities
 - Tax Issues
 - Avoiding C-corp double tax
 - Availability of fringe benefits
 - State franchise and minimum tax issues
 - Minimizing social security taxes
 - Income tax issues



"Sure, it's a low-paying, repetitive, mindless, meaningless job, but, with all due respect, you are a chicken."



"Why am I talking this loud? Because I'm wrong."

SELF EMPLOYMENT TAXES IN AN S-CORP

- ▣ The Social Security Game has been a major tax planning opportunity in S-corps for several decades
 - ▣ FICA taxes on reasonable salary only
 - ▣ IRS has never liked it, but the rules were established by Congress

- ▣ In a 2002 report issued by the Treasury Inspector General, the IRS was criticized for not paying enough attention to shareholder compensation in S-corps

- ▣ This report made the following recommendations:
 - ▣ Auditors should be provided with software to aid in determining reasonable officer compensation levels for a variety of occupations
 - ▣ S-corp distributions reported on Schedule M-2 of Form 1120S should be input into the IRS computer system during return processing and thereby be made available through a master database. Classifiers could then tap into the database and flag “suspect” Forms 1120S for audit
 - ▣ The IRS should launch a nationwide initiative to monitor S corporation officer compensation examination issues
 - ▣ The IRS should develop materials to educate taxpayers and their representatives about S-corps officer compensation issues

- ▣ In response the IRS has
 - ▣ Undertaken a study of shareholder compensation in S-corps
 - ▣ Is considering treating S-corp shareholders in the same way general partners are treated on SE issues
 - ▣ Become more active in attacking abusively low shareholder salaries
 - ▣ The volume of court cases has increased dramatically
 - ▣ The IRS is winning most of the cases
 - ▣ But when the cases are examined it looks like the IRS is only challenging clearly abusive situations
 - ▣ The cases provide minimal guidance for what a reasonable salary is

- ▣ There should still be room to play the social security game when a legitimate attempt is made to set salaries at reasonable levels
 - ▣ Document the file for how salaries are set
 - ▣ Good industry statistics are generally available
 - ▣ But salary must always be customize to the individual situation, including activity levels and profitability

A conscience is what hurts when all your other parts feel so good.

SELF EMPLOYMENT TAXES IN AN LLC

- General partner must usually report all pass-thru income by the partnership as SE (FICA) income
- Limited partner generally doesn't report SE income on partnership pass-thrus, except
 - ☒ Guaranteed payments (any partnership distribution determined without reference to partnership income)
 - ☒ Active involvement by the limited partner in the trade or business
- A partner who is both limited and general usually follows general partner rules for all partnership pass-thru income
- Salaries paid by an S-corp or C-corp are generally SE income
 - ☒ Excess distribution by a C-corp are dividends not subject to SE tax
 - ☒ Excess distribution is an S-corp are also not subject to SE tax
- But what about an LLC?
 - ☒ An LLC electing Schedule C treatment pays SE tax just like a proprietorship
 - ☒ An LLC electing S-corp tax status pays SE tax just like an S-corp
 - ☒ But an LLC taxed as a partnership is more complex
 - ☐ Since all partners have limited liability, are they treated like limited partners?
 - ☐ Limited partners pay SE tax on guaranteed payments
 - ☐ But, there is no obligation to pay any guaranteed payments
 - ☐ Does this mean all income can escape SE tax without any attempt to pay a reasonable salary?



"I like to think of myself as a nice guy. Naturally, sometimes you have to step on a few faces."



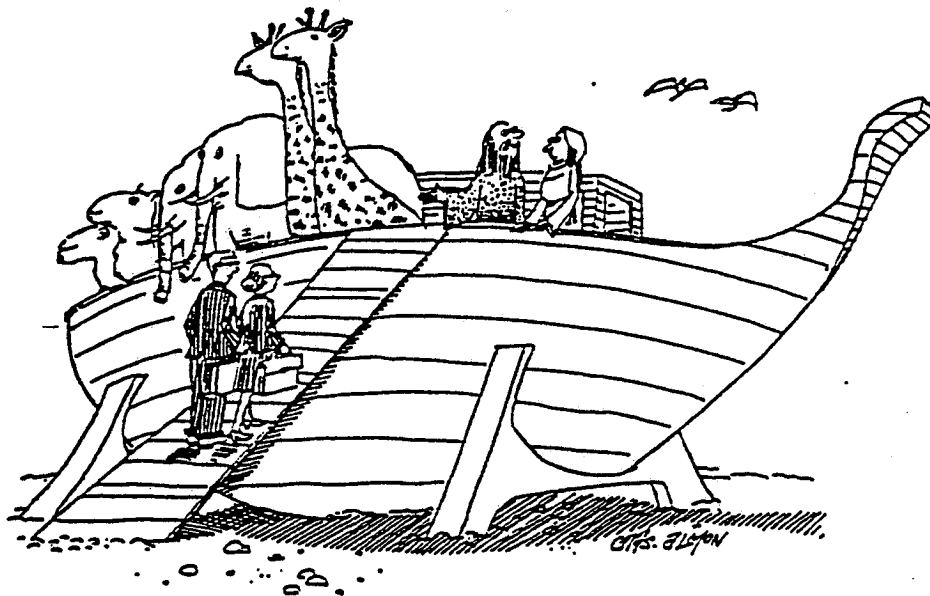
"I can tell you one thing. Being rich beyond one's wildest dreams doesn't go as far as it once did."

SE TAX IN AN LLC

- ⊕ The IRS issued proposed regulations in 1994 and 1997 to deal with this issue
 - ⊕ But the TRA of 1997 blocked any of these regulations from becoming final
 - ⊕ IRS concedes their proposed regulations have no validity
 - ⊕ IRS has provided no further guidance

- ⊕ Aggressive tax planners may claim this opens the door for no SE tax on LLC income. But the IRS has weapons to fight back
 - ⊕ Since everyone participates in management, aren't all owners really general (not limited) partners
 - ⊕ In many cases they may be carrying on an active trade or business which subjects income to SE tax anyway
 - ⊕ In a professional corporation with minimal capital investment, what generates income other than personal services
 - ⊕ Impute a reasonable salary for services performed
 - ⊕ Substance over form (LLC's may be a recognized entity for state law purposes, but the IRC doesn't recognize them as an entity entitled to any particular tax rules - must be taxed like some other entity)

- ⊕ Recommended approaches
 - ⊕ Elect S-corp tax status
 - ⊕ Elect partnership tax status but pay or impute a reasonable salary



"They say they're a species called 'lawyers.' What's the harm?"

SELF EMPLOYMENT TAX IN A SOLE PROPRIETORSHIP

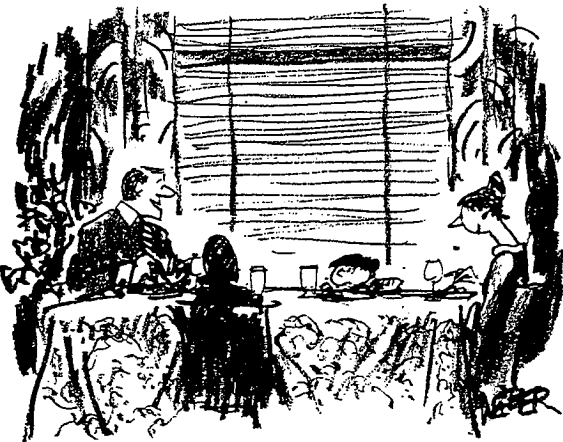
- ❁ Many clients operate as a sole proprietorship where
 - ❁ One spouse does most of the work
 - ❁ The other spouse helps out on occasion by typing, keeping the books, or providing an extra hand
 - ❁ All income is reported under the dominate spouses name

- ❁ The net result is no income or SE tax for the less involved spouse
 - ❁ Since the dominate spouse reports the income the IRS will almost always collect its full share of income taxes
 - ❁ Unless the dominant spouses' SE income is under the OASDI Maximum Base (106,800 in 2009) a correct SE tax has not been paid

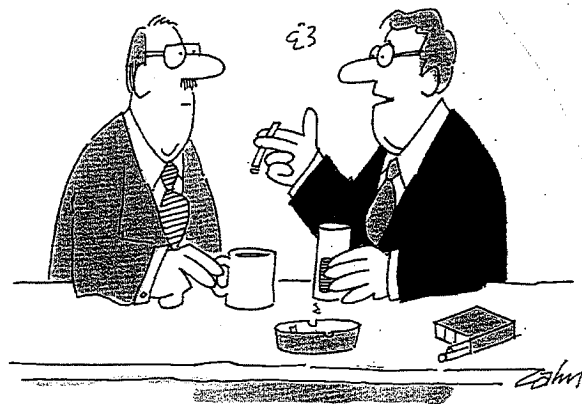
- ❁ Upon audit, the IRS could
 - ❁ Merely reallocate the income and issue a deficiency notice for tax, penalty, and interest
 - ❁ Rule that the entity is really a husband and wife general partnership
 - ❁ Then all income (except guaranteed payments) must be allocated between them
 - ❁ Partnership tax return hasn't been filed
 - ❁ Partnership tax elections have not been made
 - ❁ SE tax has been underpaid

- ❁ In Rev. Proc. 2002-69 the IRS announced it would not make the husband and wife partnership argument but would instead honor whatever tax return election the parties had made, if
 - ❁ Entity is owned solely by husband and wife
 - ❁ Entity has not elected to be taxed as a corporation

- ❁ This opens the door for some creative planning for SE taxes in a family owned business



"Thank you, Adrian. Parenting is a learning process, and your criticisms help."



"If you don't smoke or drink, what will you give up once your health starts to go bad?"

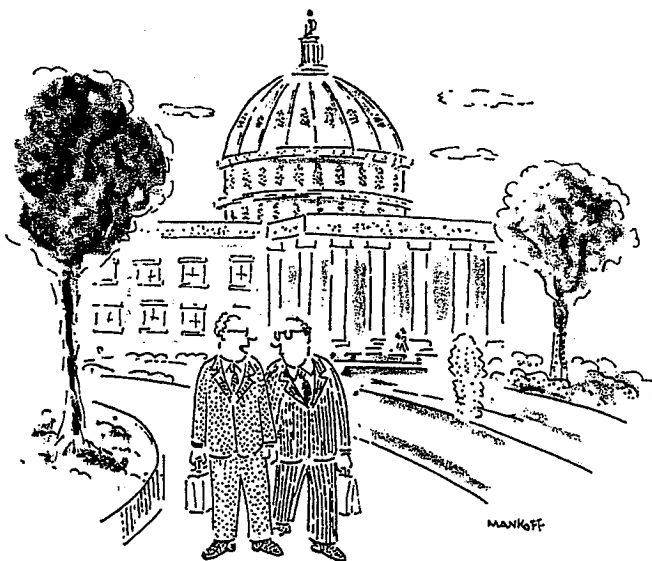
INCOME TAX ISSUES

- Since most uses we have for entities involve
 - Carrying on a trade or business
 - By more than one owner

- The IRS gives us three choices in the type of return to file
 - Partnership (Form 1065)
 - S-corp (Form 1120S)
 - C-corp (Form 1120)

- Don't automatically rule out a C-corp
 - At current tax rates, the double tax problem might not be a problem at all
 - There are plenty of tools available to minimize double tax issues

- Major tax differences between partnerships and corporations
 - In the partnership, most contributions occur at carry over basis (generally non-taxable)
 - In the partnership, most withdrawals occur at carryover basis (generally non-taxable)
 - In the partnership, income expenses and credits can be specifically allocated
 - In the partnership debt adds to basis creating an improved opportunity to deduct losses
 - In the partnership, optional step-up in basis under § 754 is available
 - Partnership have more flexibility in exchanging ownerships for services because of ability to transfer a "profits only" interest

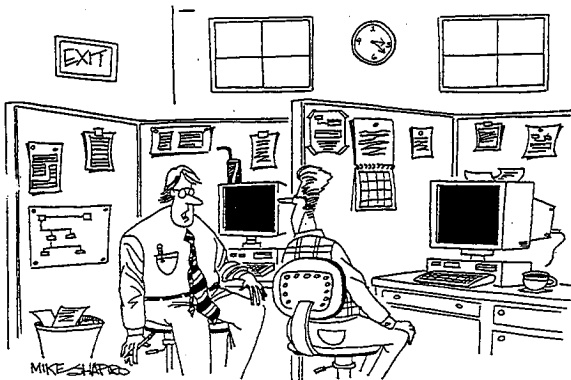


"But how do you know for sure you've got power unless you abuse it?"

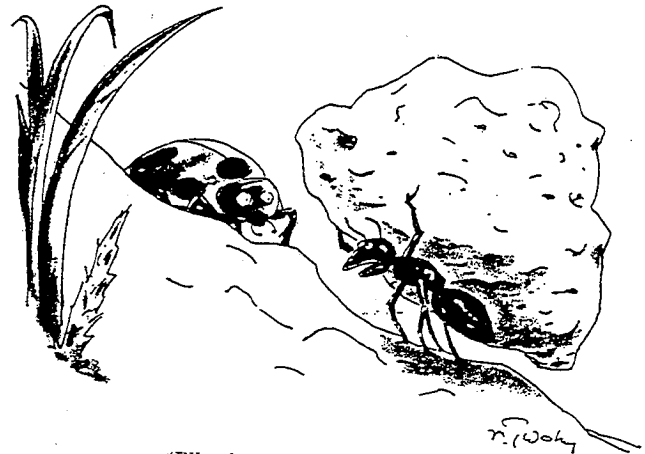


CONTRIBUTIONS TO CAPITAL

- Partnership contributions:
 - § 721 - no gain or loss is recognized upon a transfer of property to a partnership in exchange for a partnership interest
 - § 722 - PARTNER'S basis in the partnership interest equals the amount of money plus the BASIS of property contributed to the partnership
 - § 723 - PARTNERSHIP'S basis is a carryover of the contributing partner's basis
- Except in a few unusual situations (debt in excess of basis, etc.) no gain or loss is recognized by anyone when a capital contribution is made
- Corporate contributions
 - § 351 - no gain or loss is recognized upon a transfer of property to a corporation (S-corp or C-corp) in exchange for a corporate interest, as long as the contributing shareholder(s) as a group end up in control of 80% of the combined voting power and 80% of the total number of non-voting shares
- Very liberal rules regarding who is part of the "Group"
 - Must be part of a single plan
 - Commonality of interest is not required
 - Proximity in time is not required
- Conclusions:
 - Partnership contributions are nearly always nontaxable
 - Corporations have a choice of taxable or nontaxable depending on how the contribution is structured
 - Tax going in is usually capital gain
 - Step-up in basis due to the tax may get allocated to depreciable assets which produces an ordinary deduction
 - Corporations may have the option to trade an up front tax for a long-term tax savings



"I'm beginning to think that E-mail stands for 'endless mail'."



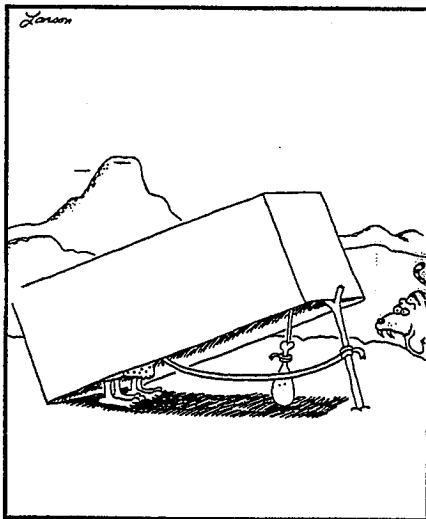
"I'll quit when it stops being fun."

DISTRIBUTIONS TO OWNERS

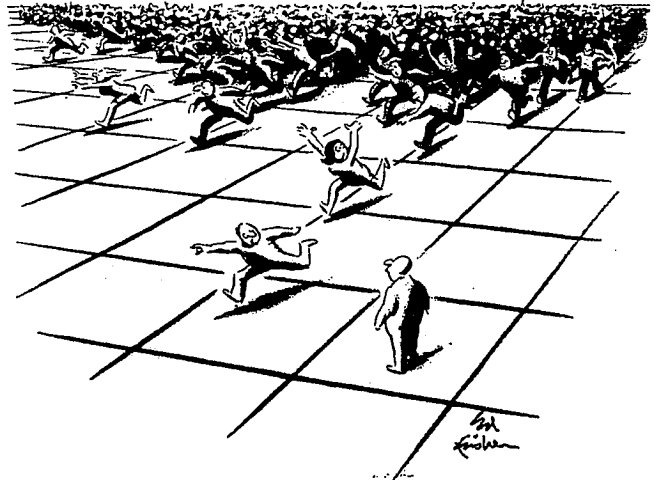
- Partnership Distributions:
 - Distributions of inventory and accounts receivable retain their character as ordinary income assets in the hands of the recipient
 - All other distributions produce no gain or loss to the PARTNERSHIP
 - Gain or loss is recognized by the PARTNER under § 731(a) only if
 - Gain or loss is recognized if the distribution involves cash or debt in excess of basis
 - Loss is recognized if the distribution involves only cash, inventory, and accounts receivable (but no other property) and the basis of assets distributed is less than the partner's basis in his partnership interest
 - Both situations are rare events

- Corporate Distributions:
 - Distributions of inventory and accounts receivable lose their character as ordinary income items unless the owner is also in the trade or business
 - Generate a gain or loss to the corporation whenever corporate basis is different than FMV
 - Generate a gain or loss to the shareholder whenever the shareholder's basis is different than FMV
 - Two Taxes in a C-corp
 - Basis adjustment results in only one tax in an S-corp

- Conclusions
 - Tax issues are nearly certain whenever a corporation is liquidated
 - Partnership provides far greater flexibility



"Shhhh, Zog! ... Here come one now!"



"Back to Square One!"

SPECIAL ALLOCATIONS

- Special allocations of income, expense, loss or credit are
 - Available in a partnership (§ 704(b))
 - Not available (except as adjustments to compensation) in a corporation
- This makes a partnership a much more flexible tax planning device
- But special allocations must meet 2 tests
 - Must have economic effect
 - The economic effect must be substantial
- Economic effect requires
 - Maintenance of special capital accounts (basis accounts) in addition to regular capital accounts (two sets of books just for tax purposes)
 - Required in the partnership agreement
 - OR actually maintained by the partnership
 - Liquidating distributions must be made in accordance with positive capital balances
 - A partner with a negative capital account must restore the deficit
 - By an actual contribution (Deficit Restoration Order)
 - Or by recognizing more income at some later point (Qualified Income Offset)
- Serious effect
 - The DRO trades an extra deduction for actual cash (very serious cost)
 - The QIO trades an expense now for income later
- Substantiality generally requires that if one partner gets a benefit from the special allocation, that same partner or a different partner must suffer a matching (but not necessary equal) detriment
- Special allocations can be a huge advantage
 - But not as advantageous as most of our clients think it is



"No, no, Senator, no thanks are necessary at this time."

**History records
no more gallant struggle
than that of
humanity
against
the truth.**



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DEBT AND BASIS

- More Basis is Good!
 - § 469 limits the deductibility of losses to the balance in a partners basis account
 - Basis also affects the amount of gain or loss on sale or liquidation of the ownership interest

- Comparison
 - Under § 752 debt adds to a partner's basis in his partnership interest
 - No addition to basis for debt in a C-corp
 - Only debt from the owner to the entity adds to basis (special debt basis) in an S-corp

- But debt change constantly
 - By normal debt amortization payments
 - By business transactions

- And changes in debt can produce some surprises

Example

A and B form the equal AB partnership with the following contributions. A contributes property with a basis of \$100 and a fair market value of \$600, but subject to a debt of \$300. B contributes property with a basis of \$200 and a fair market value of \$400. It is subject to a debt of \$100. Six months later, C is admitted as a 25% partner in exchange for \$200 cash.

Neither partner A or B recognizes income or loss as a result of his original contribution to the partnership. The partnership taxes a carryover basis of \$100 in A's property and \$200 in B's property. A's basis in his partnership interest is zero (\$100 property contributed + \$200 increase in his share of partnership debt - \$300 debt transferred to the partnership). B takes a basis of \$300 in his partnership interest (\$200 property contributed + \$200 increase in his share of partnership debt - \$100 debt transferred to the partnership).

C's subsequent entry, however, changes the partners' debt sharing ratios. C now shares 25% of the partnership debt, reducing A's and B's shares by 12.5%, or \$50, each. This reduction is treated as a cash distribution under Section 752(b) of \$50 each to A and B. This deemed distribution reduces B's basis in his partnership interest to \$250. A's deemed \$50 distribution triggers a \$50 taxable gain under Section 731(a). His basis remains zero.

There is always one more imbecile than you counted on.

STEP UP IN BASIS

- An owner of any kind of entity could get an opportunity for a step-up in basis in various ways
 - Death of the owner
 - When a new owner buys in and pays the current FMV
 - Etc.
- Definitions
 - Inside basis is the entities basis in the assets it owns and, in most cases, depreciates
 - Outside basis is the sum of all owner's individual basis in their ownership interests
- When outside basis of a C-corp or S-corp shareholder increases
 - The extra basis is stuck on the outside
 - Generally the basis is useable only
 - To reduce gain on an eventual sale
 - To support pass-through losses in a S-corp
- When outside basis of a partner in a partnership is greater than or less than inside basis
 - An election under § 754 allows the partnership to bring the extra basis inside
 - Allocate extra basis to partnership assets
 - May increase depreciation
 - Excess depreciation is specially allocated back to the partner who caused the step-up (§ 704(c))
 - OR the partnership may decline to make the election
- CAVEATS:
 - Once made the election is irrevocable and applies to all future year
 - Step-down in basis is also possible



"I move that we accept the treasurer's report as having been gloated over."



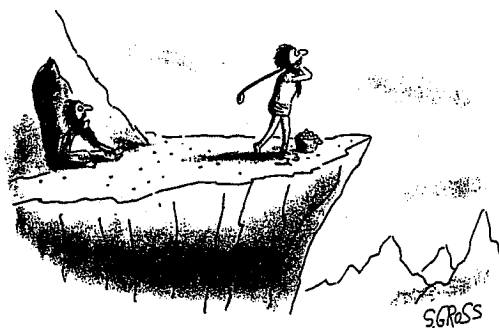
"I just want to say that I'm perfectly willing to serve as treasurer, provided every penny doesn't have to come out exactly even."

OWNERSHIP INTEREST IN EXCHANGE FOR SERVICES

- Both § 351 and § 721 specifically prohibit their application to exchanges for services
 - Also normal rules relating to compensation for past, present, or future services would not apply
- § 83 fills the gap by providing that income must be recognized whenever a taxpayer receives property in connection with the performance of services
 - A substantial risk of forfeiture delays the tax until the risk lapses, but imposes the tax at the FMV on the date the risk lapses
 - But does a profit only interest qualify as property - the courts have been inconsistent
- When a partnership interest is exchanged for services the tax consequences are based on two separate transactions under § 707 regulations
 - A proportionate share of all partnership property is treated as if it were distributed to the service partner in payment of services rendered
 - Treated as a guaranteed payment which is income to the partner and deductible by the partnership
 - The partnership property is then contributed back to the partnership in exchange for a partnership interest
 - Non-taxable under § 721
 - But partner's outside basis is equal to the fair market value of the property contributed (amount of compensation reported and therefore the basis of the property immediately prior to the contribution)
 - PARTNERHIP's basis in its assets is also increased by the compensation reported
- But what is the effect on the other partners?
 - The partnership made a guaranteed payment which generates a deduction
 - But the guaranteed payment was paid in property which generates a gain or loss at the partnership level equal to the difference between the fair market value and the PARTNERSHIP's basis



"As president of an independent island republic, I'd like to apply for a loan from the World Bank."



"If you're so enlightened, how come you can't lick that slice?"

RISKS OF FORFEITURE

- § 83 allows a PARTNER to make an election of when to recognize the income
 - When the partnership interest is transferred, or
 - When the substantial risk of forfeiture lapses
- Substantial risk of forfeiture can include
 - Future services are required before the interest vests
 - Certain income projection or other contingencies must occur before the interest vests
 - Etc.
- If the PARTNERSHIP elects taxation in the earlier year
 - Tax consequence is recognized immediately (ordinary income when compensation for services are involved)
 - Fair market value in this year is used to determine income
 - Future appreciation is taxed when the partnership interest is sold (capital gain)
- If the PARTNER elects taxation in a later year (when the risk lapses)
 - No tax consequence is recognized in earlier year
 - Tax consequence is recognized later (all ordinary income when compensation for services are involved)
 - Fair market value at the time of income recognition is used to determine the amount of income (usually a higher number)
- In nearly all cases the PARTNERSHIP gets the deduction in the same year the PARTNER recognizes the income

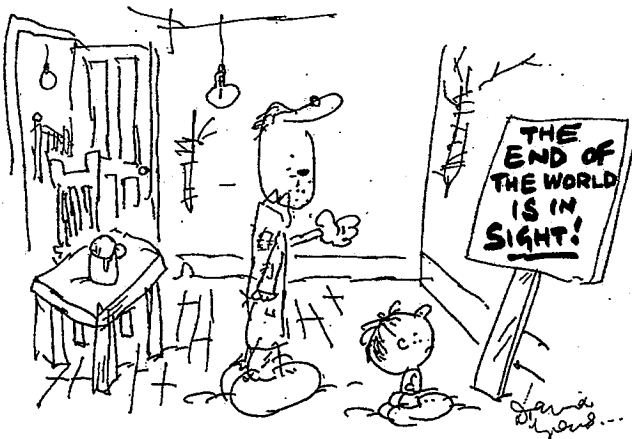
EXAMPLE

If A's interest does not vest for five years, the initial transfer has no immediate tax consequences unless the Section 83(b) election is made. Assume no election is made. At the end of five years, the partnership's assets have appreciated to \$40,000 and its basis in those assets has declined to \$10,000. Upon lapse of the restrictions (i.e., at the end of five years), A will recognize a \$10,000 gain and will take a \$10,000 inside and outside basis in the partnership. The non-service partners will be entitled to a \$10,000 deduction, offset by a \$7,500 gain. The partnership's basis in its assets will be increased to \$17,500 of which \$10,000 is attributable to A under Section 704(c) and \$7,500 to the non-service partners. If an election under section 83(b) had been made, the consequences of the transaction would have been reported in the first year.

Always yield to temptation, because it may not pass your way again.

TRANSFER OF AN INTEREST IN PROFITS

- A transfer of an ownership interest in exchange for services generates income
- So creative CPAs have turned to an interest in profits, detached from the ownership interest
- Revenue Procedure 93-27 says (because of the valuation problems inherent in a profit only interest) the exchange of an interest in profits for services will not generally be taxable unless
 - The profits interest relates to a substantially certain and predictable stream of income; or
 - The service partner disposes of the profits interest within two years; or
 - The profits interest is in a publicly traded partnership
- Note: Corporations cannot separate profits from ownership, so can't play this game
- History of a profits only interest
 - § 721 seems to exclude it from taxation
 - The Tax Court in Sol Diamond ruled that it was fully taxable when received
 - The IRS (which won in Sol Diamond) has announced that it will not follow this decision
 - The IRS has issued a series of conflicting opinions which attempt to rule that the profits only interest is sometimes taxable and sometimes non-taxable, depending on the detailed circumstances



"One day, son, all this will be yours."

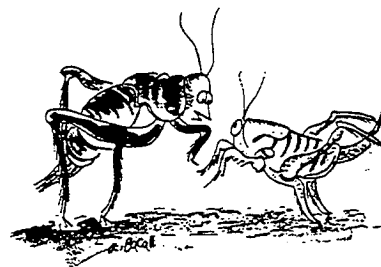


THE CAMPBELL CASE

- Mr. Campbell helped a partnership get organized and find investors
- His compensation was a percentage of future profits of the partnerships, over a long period of time
- The Tax Court found the profits only interest to be taxable
 - The usual problem in these cases is how to value the profits only interest
 - But Campbell issued a prospectus to potential investors which contained future income projections
 - The Tax Court simply discounted these income projections (but does anyone really rely on income projections in a prospectus, its all hype anyway)
- The Eighth Circuit reversed the Tax Court decision
 - The IRS which won in the Tax Court, argued against the Tax Court decision claiming
 - The Tax Court erred in finding a profits only interest received in exchange for services to be immediately taxable
 - And Campbell performed the services in the capacity of the EMPLOYEE, rather than a PARTNER
- The Eighth Circuit examined § 707(a)(2) which deals with taxation of payments to a PARTNER when the PARTNER is acting in a capacity of a non-owner (employee).
 - If 707(a)(2) is to have any meaning, then whether Mr. Campbell was acting as a PARTNER or EMPLOYEE when performing the services must be important
- Campbells profits only interest was
 - Non-transferrable (could not be sold)
 - Not likely to provide any short term benefit (losses were expected for several years)
- The Eighth Circuit expressed doubt that Campbell was acting as an employee
 - His only real chance for a profit was to remain a partner for the long term
- But the Eighth Circuit ultimately ruled the profits only interest to be non-taxable because there was no way to put a value on it (which was the taxpayer's original argument).



"I wheeled when I should have dealed!"



"Be careful! The light at the end of the tunnel could be an ultraviolet electronic bug zapper."

